Digital Service Taxes and the Broader Shift From Determining the Source of Income to Taxing Location-Specific Rents

Daniel Shaviro, NYU Law School

Sat Pal Khattar Visiting Professor of Tax Law Lecture

NUS Faculty of Law

January 14, 2020

What are digital service taxes (DSTs)?

Corporate income taxes have been hard to apply to global firms with digital platforms (e.g., Facebook, Google).

In a # of mainly EU countries, DSTs have emerged as an alternative. (France, Italy, Austria, Spain – UK to follow? OECD & EC interest.

Tax (say, @ 2 or 3%) relevant **gross revenues** – e.g., from ads directed at one's users.

Apply just to digital platform companies, & highly selective even as to them (type of business, gross revenue thresholds).

Controversial due to targeting & gross revenue focus – but (probably?) outside the scope of income tax treaties.

But is this a DST talk?

Not the talk's main focus! (Only 14% of text in the draft paper.)

Rather, an important & useful illustration of broader international tax issues associated with (but extending beyond) rise of digital economy.

Broader theme is future of the corporate income tax, & how apply it to the brave new world of IP (not just digital) that the rise of companies as Facebook & Google helps to exemplify.

Background: the rise of GAFAM

Note the recent rise of super-profitable, mainly US MNCs that use IP to (a) reap large global profits, (b) pay low global taxes.

Led/epitomized by GAFAM (Google, Apple, Facebook, Amazon, Microsoft).
("FAANG" if we sub in Netflix for Microsoft).

Often are technology companies – but not always (e.g., Starbucks).

High profits/low taxes bound to inspire pushback, & perhaps all the more so when so prevalently outbound from the US.

Limited US residence-based taxation added to the insult, if not the injury, to EU countries that found source-based taxation hard to apply.

GAFAM issues -> 4 main topics

1) Source of income / site of “value creation”: Incoherent? Fixable? Production vs. market countries?

2) Taxing large profits from IP: Rents or quasi-rents? Are there location-specific rents (LSRs)?

3) Nations as the key actors: So not just about global welfare, but what self-interested countries should or will do.

4) Are DSTs appropriate? For digital? More broadly? Relevance of digital platforms? Of 2-sided markets? Of user participation?

TOPIC 1: SOURCE OF INCOME / SITE OF “VALUE CREATION”

Source: the underlying theoretical debate

Source of income crucial to taxing MNCs. But, longstanding dispute: what does it mean? Does it mean anything?

Ault-Bradford (1989): Haig-Simons income pertains to people, doesn't have a source!

Per Kane (2015), this amounts to claiming that ascribing a source to income is a "category error."

I disagree! It's perfectly reasonable to ascribe a source to income based on **where relevant things happened**.

But what things?

Theorizing source

Example 1: Say I grow vegetables on my rooftop in NYC, sell them to a restaurant down the block that uses them in menu items.

Clearly US source – as both *production* & *consumption* occur in the US.

Example 2: Say that, from my NYC home, I write novels in Tagalog that are sold exclusively to people in the Philippines.

Clearly US source if one looks to the place of production; clearly Philippine source if one looks to the place of consumption.

Clearly not, say, Belgian, Singaporean, or Brazilian source!

Basing source on the place of production vs. consumption

Unfortunately, logic cannot dictate the choice between production-based and market based theories of source.

Cf. the "Coase problem" in tort causation.

Just as the contiguous railway & wheat field were needed to yield the dire result, so one needs both the production country & the market country for the particular activity & transaction to have yielded surplus.

Existing practice fails to offer a consensus answer. Consider transfer pricing in practice, the need for permanent establishment (PE) rules.

What **is** vs. **isn't** hard about source?

While neither logic nor consensus practice permits one to choose between production-based & consumption-based views of source …

… otherwise it's often less hard than one might think!

Under both production-based & consumption-based views, may sometimes face difficult dilemmas, but often it's surprisingly clear.

E.g., under consumption-based, where were the ultimate consumers? But even under production-based, current rules could in principle be made far more workable & less manipulable than they currently are..

Could production-based sourcing be made easier?

Consider bilateral monopoly profit splits. (Say X-Co-US & Y-Co-Singapore would earn $100 each if separate, $250 total if co-owned – so where was the extra $50 earned?)

Insoluble in theory – but maybe not big a problem in practice.

E.g., we know where leading US MNCs actually created valuable IP under a production-based view. (Hint: their overseas cost-sharing affiliates did very little.)

But production / corporate residence countries are reluctant to tax heavily due to (a) tax competition & (b) political economy issues.

Market countries might be more willing. But while current rules don't rule out market-based sourcing, they also create some huge obstacles.

Source taxation difficulties re. GAFAM et al

One or more of the following often permit highly profitable IP-driven MNCs to avoid source-based taxation:

--Permanent establishment (PE) rules,
--Transfer pricing between local & outside affiliates,
--Intra-group cash flows such as interest & royalties.

Two-sided markets (a la Facebook & Google) can cause profits from access to domestic users to depend on $$ paid by non-residents.

But consider a mundane non-digital example with clear PE & no 2-sided market: Starbucks' bricks-&-mortar stores (recent topic of huge UK controversy).

Can't measure Starbucks' "true" market country income without defining source! (So, face production-based vs. market-based after all.)

How much did Starbucks "really" earn in the UK?

Starbucks claimed to be losing ££ in the UK – despite having 988 stores there (246 in London alone).

Used transfer pricing, royalty/interest flows to create fake UK losses.

But were significant ££ earned there, under a production-based view?

Clearly not – just routine / normal returns. US-created IP, US-monitored "Starbucks experience," not based on finding unique baristas.

Still, once large profits are being earned through UK stores, (a) the UK tax authorities have a shot, (b) UK voters & policymakers may want some tax ££, & (c) who can blame them?

OECD and “value creation”

Source by another name – to be revivified by addressing transfer pricing, permanent establishment (PE) rules.

But OECD, in defining value creation, was hamstrung in its ability to choose overtly between production-based & market-based definitions.

Market countries wanted a piece of the action.

Production / residence countries, while reluctant to tax aggressively themselves, were less than eager to recede officially or completely.

Value creation’s one significant use, therefore, was as a “negative source rule” ($$ not earned in tax havens). So OECD is now moving on from it.

One way of moving beyond "value creation"

There's been much recent talk of shifting tax base to market countries – based not on source theory, but end-consumers' relative immobility.

Recent proposals include: (1) sales-based formulary apportionment (SBFA),

(2) Residual profit allocation by income (RPAI),

(3) Greater use (in the US especially) of VATs,

(4) Replacing corporate income taxes with destination-based cash flow taxes (DBCFTs).

For our purposes, just **2** proposals, not **4**. RPAI ≈ improved SBFA; DBCFT is just a VAT + additional features that we can ignore here.

What if SBFA/RPAI &/or DBCFT is adopted?

This would help source countries up to a point.

E.g., the likes of Starbucks & Amazon would have difficulty avoiding corporate income tax everywhere.

But what about, say, Facebook & Google? More generally:

(1) Might still in practice result in unequal taxation by industry, due to differential access to (perhaps unintended) tax planning opportunities.

(2) Might not allow market countries to tax inbound sales by super-profitable MNCs as heavily as they might (reasonably) like.

TOPIC 2: TAXING HUGE PROFITS FROM IP

Taxing global rents

GAFAM et al firms observably earn huge profits that reflect their IP.

Are these economic "rents"? If so, then in theory (1) they shouldn't be tax-deterred at rates below 100%, (2) source country tax should be borne economically by the shareholders.

While they look like rents ex post, were they so ex ante? If not, a risk of globally overtaxing mere "quasi-rents"?

Individual countries might not care! Time consistency, spillover.

Plus, note the at least theoretical danger of "Monty Python taxation."

Monty Python taxation

Man in a silly bowler hat: "To boost the British economy, I'd tax all foreigners living abroad."

Thus, if taxing rents, why just tax one's own? Why wouldn't, say, the UK want to tax profits that French firms earn in China?

Luckily, countries appear not to try to do this much (if at all).

Not just due to limited taxing power & jurisdiction – also based at least implicitly on not overly undermining global cooperation / inciting chaos.

For taxing global rents / quasi-rents, concern about global over-taxation may be allayed if readily divisible into location-specific rents (LSRs). Analogy to natural resource taxation? (See recent work by Cui.)

Defining LSRs

Not quite as easy as where the oil or coal come out, due to the issue (same as for source) of production countries vs. market countries.

E.g., Facebook rents are created in the US, earned country-by-country.

Firm-specific rents created in the US = sum of the market-side LSRs to be earned in each country. (Although note, e.g., AirBnB & residence vs. geography-based.)

But production or corporate residence country vs. market country is a familiar problem in international tax policy.

Reasonable to think it won't get any more out of hand here than it generally has elsewhere.

TOPIC 3: NATIONS AS THE KEY ACTORS

Who are the relevant actors in int'l tax?

Lots of analysis discusses global welfare – what all countries should collectively do if all were altruists.

Not very realistic! Although it's true that there are global institutions, shared interests, possible gains through cooperation.

I like to stay grounded in the real world of national actors.

Countries are mainly interested in own residents' welfare. But may act either **unilaterally** or **strategically**.

Unilateral: other countries matter (e.g., tax competition), but suppose what they do won't be affected what by you do.
Strategic: what you do may affect what they do (whether or not they're being consciously strategic). So need to take that into account!

Unilateral & strategic national welfare

Need realistic behavioral models. It isn't all rationally cold-blooded!

E.g., cooperative / good faith norms -> aversion to "Monty Python" taxation?

Divergent national interests are inevitable! So, when Country A advances its self-interest detrimentally to Country B, policymakers in B should consider reasonableness.

E.g., say EU countries want to tax highly profitable & largely untaxed inbound sales from US MNCs.

Is this unreasonable?? Something the US wouldn't want to do the other way around??

TOPIC 4: ARE DIGITAL SERVICES TAXES (DSTs) APPROPRIATE?

Do digital companies pose special tax issues?

Facebook & Google et al use IP to (1) earn high global profits & (2) pay low global taxes.

Partly just from IP. But they also have (a) digital platforms, (b) 2-sided markets, (c) user input. What relevance to these factors?

Digital platforms: may lead to (a) low marginal cost of operating in a given country, (b) ease of avoiding PE.

2-sided markets: connecting users & advertisers -> don't have to charge an arm's length price to users considered separately.

User input: helps market countries to feel good about imposing taxes, but otherwise irrelevant!! (Facebook vs. Netflix vs. Hulu.)

Digital service taxes (DSTs)

Again, controversial due to: (1) selective application by industry, (2) use of gross revenues in tax base, (3) revenue thresholds for applicability.

Selective application: may **want** to vary by industry! Tax planning opportunities may anomalously vary under “neutral” taxes, based fortuitously on firm or industry business models.

Gross revenues: while bad to tax in theory, note (a) low marginal cost for operating in a given country, (b) high intra-group manipulability.

Revenue thresholds: clearly being used for hand-tailoring – but how surprising or terrible is that, all things considered?

US vs. EU (or US vs. the world?)

Willie Sutton on why he robbed banks: “That’s where the money is.”

Equally true of hand-tailored application of EU DSTs to the likes of Facebook & Google. That’s where the huge untaxed global profits are!

But from a US standpoint, how unreasonable are our EU friends being? Would we act differently in their shoes? What if EU companies were making huge profits (which EU countries weren’t taxing) by accessing the US market?

And does the US currently need to pick more fights and make more enemies?